CYCLES RESEARCH EARLY WARNING SERVICE

by Bill Meridian

Summary

On July 30, this service cancelled the sell signal of last January, and issued a trading buy signal.
As of the close on August 30 I am moving back to the bearish position that had been maintained from January through July.

The market will likely sell off into mid-October, when I shall move back to a bullish stance. The best rally of the year will then ensue, carrying the averages up into January, at least. This decline appears to be widely anticipated, which is not the type of sentiment that one wants to see at a top. This means that the decline will not unfold in an expected way. Perhaps it will not make a new low.

Two books became available on July 15: the third edition of *Planetary Stock Trading ($55 domestic and $70 foreign)* and the first edition of *Planetary Economic Forecasting ($39 domestic, $49 foreign).* The latter book is the first detailed study of the USA economy in relation to the outer planets. It is based upon a unique monthly index of over 200 years of USA production data. Both are available from Cycles Research at 666 5th Ave., No. 402, Lower Arcade, NYC, NY 10103.
I am pleased to say that both books are doing well. The surprise is that *Planetary Economic Forecasting* is being ordered by Wall Street firms and banks. This proves what I have observed over the years. There are plenty of people out there simply looking for some proof, or some guideposts to follow in the search for a link between the markets and the planets.

Analysis

The last letter stated that "The high can fall anywhere from the 20th to September 3." It appears that the high was on August 22, a bit earlier than expected. Although I gave that date range, I thought that the high day would be on the 3rd. With the market already having fallen into this date, it is possible that the market will make a temporary low this week. The 3rd-4th is a turning point. But I think that the overall trend remains down. If this turning point is not a high, the 9th-10th is a high. The 19-20th date is likely a low, as it was one year earlier. The last projected turning point of the month (25-26) is probably a high. September will likely be down, but not by as great a percentage as the last two Septembers.

Technicals Are Mixed

September will be a down month, but there are several developments that are more encouraging for the bull. Many people have now made the same forecast for a down month, and there was some sign of capitulation in July that was not evident last month. The general rule of thumb is that the majority is rarely right, so I dislike having lots of company when making a forecast. And, capitulation usually marks an important low. In the last letter, I wrote that there were partial signs of this phenomenon, such as the concern about the market in the media and the attention of the President. However, put-call ratios usually skyrocket at such lows, and they remain high as the market recovers. This is a sign of disbelief, or the proverbial wall of worry that the market must climb. There was one good sign of capitulation in July. There was a record outflow from equity funds- $49 billion. Most went to bond funds. This is one sign of investors' throwing in the towel on equities, thereby lending more credibility to July as a major low. Here are two more improvements. The ratio of NASDAQ volume to NYSE volume has fallen below 100% for the first time since 1998 (from a high of 200% in 2000). This is a sign of less speculative buying and less interest in the NDX; this is bullish. Corporate insiders usually are the best judges of the assets of their companies in light of current economic conditions. The ratio of insider sells to buys is a gauge of their thoughts. The ratio had been over 4 but has fallen to less than 2 recently. This indicator is not a precise timing tool, but it does show that insiders feel that their corporate assets are now more reasonably priced.

Cycles are Bearish

On a cyclic basis, the prospects are bearish. The last letter indicated that there were several cycles in decline. One was Mars opposite Uranus on August 24, the peak in this overall 1.8-year cycle. This one is a bit tricky in that the Dow, since 1915, has traditionally popped up for about 10 days afterward, and then the market has fallen. So the effect of this one lies in front of the market.
In addition, more than sixty percent of the Septembers two years after an election have been bearish. This, added to the planetary cycles is probably enough of a depressant.

Most technical readings support this view. I maintain a diffusion index that is based upon market breadth on a 25-day basis, thus creating an intermediate indicator. It ranges between 45 and 55, and it hit the latter number last week, describing an overbought situation. In addition, the market gained too much ground too fast coming off of the July low. Volume historically has fallen off the most from July to August, but this August saw a very sharp sell-off. This is a sign of a lack of buyers. If there are no buyers, for any product, the price will fall until buyers are attracted.

Look for an October Low

The probabilities favor a strong fourth quarter. This takes us up to January. The year 2003 is the year before the election, historically the best in the 4-year cycle:

Here are the average gains since 1914:

Election year-	6.26%
One Year After-	4.44
Two Years After-	6.04
Three Years After-	**16.80**

The theory is that the Fed juices the money supply up to support the president. But, an unpublished analysis of this cycle shows that the 4-year rhythm exists in countries where there is a 6-year election cycle, an 8-year cycle, and no elections at all. There is a 4-year cycle, no matter what the cause is.

Technology and Fundamental Analysis

I follow the technology sector closely, and the fundamentals are not very strong. Surveys suggest that IT budget growth will be about 3%. Capacity utilization is low at 64%. Earnings revisions are still negative, running at a forecasted 15% this year, down from 50% at the beginning of the year. Because many tech companies still do not expense their options, the earnings remain suspect. Valuations are still relatively high, with the stocks trading at 25 times estimated 2003 profits. Bull markets require strong fundamentals to fuel sustained share price growth. Without this, the best we can hope for are trading rallies based upon excessive pessimism and excess liquidity, like the one we are experiencing. I do not foresee a strong recovery until 2004-2005.

According to Merrill Lynch’s quant unit, earnings growth is the least predictable since 1941. The three-year standard deviation has risen from the 5% to 15% range, to 30% to 35%. Most funds are driven by fundamental analysis of earnings, and this job has become much more difficult. But, they have not yet admitted it. They are simply waiting for the storm to pass. I ran into a salesman who represents US and European funds here in the Mideast. He told me that the big fund’s solution has been to fire bearish fund managers and to hire bullish ones.

The Market is Looking Ahead at the Economy, and Dislikes What it Sees-Part Three

The basis of all investments lies in the underlying fundamentals. Technical analysis studies the nexus of how markets react to the fundamentals. Add psychology to the fundamentals, and you get market prices. These reactions may not be rational. I was at Paine Webber when the AIDS crisis came to public awareness. Carter Wallace had condoms in it product line. This is only five percent of the company's sales, but the stock doubled. A 100% rise based upon 5% of revenue? It did not make sense, but it happened.

The real estate market holds the key to the economy at the moment. Because housing is such a large part of the economy, and is the one part of the economy that is keeping business going, I keep a close eye on it. I have already mentioned that the stocks have given some bearish signals on a monthly basis. All things begin and end with fundamentals, and these are slipping. In past recessions, housing starts fell from about 20% to 50%. The biggest decline since 2000 has been about 5% in 2001, so this sector is overdue for a correction or consolidation. The bubble in housing has been fueled by the excess liquidity created in response to 9/11, in addition to easy financing.

Ned Davis Research has calculated that household wealth currently consists of 55% stock and 45% housing. The stock component has fallen 33% since 2000 while the housing component has risen 20%, creating a net overall loss of 9% in household wealth. Thus, housing has helped to offset the stock decline, preserving the wealth effect to an extent. A fall in housing, however, would be a blow to the consumer. An academic study by economist Robert Shiller and two colleagues focused on consumer spending in the USA and 13 other developed nations. They found that the wealth effect of real estate on consumer spending is twice as great as comparable changes in stock market wealth. In the USA, a 10% gain in real estate wealth produces a 0.62% gain in consumption while the same increase in stocks creates a 0.2% to 0.3% increase in spending. Shiller reasons that stocks are less easy to liquidate because they may be locked away in retirement accounts, and home equity loans are easy to obtain. So the stock market decline will affect spending much less than a real estate decline.

The fact is that, for house prices to continue advancing, either incomes will have to rise sharply or interest rates will have to fall significantly. The public's ability to keep payments up is fading. The Wall Street Journal reported that housing payments are the highest percentage of disposable income since the Fed began tracking the numbers. Ian Morris, chief economist at HSBC, has computed a ratio that proves the point. He divided real estate wealth by disposable income going back over 50 years. The ratio currently stands at 1.62, the highest level in history. The highest number previously was 1.59 at the height of the 1989 real estate bubble.

In addition, credit standards of buyers are falling. In order to keep the bubble expanding, lenders are offering many concessions. Down payments have fallen. Over half of existing mortgages (versus 7% in 1989) have down payments of 10% or less. Home equity loans jumped to $630 billion in 2000 from $289 billion in 1995. As mortgage debt has built up, homeowners equity has sunk from 70% in 1985 to 55% currently. Most households have sufficient cushion to absorb some of the fall, but the fact is that household liquidity is at a 57-year low. The percentage of household liquid assets divided by household liabilities is currently 83%, well below the 40-year norm of 135%, according to Ned Davis Research. Since 1988, this number has fallen from the norm to its current low level. Consumers have made up the difference by assuming record levels of debt.

Already delinquencies of FHA mortgages have risen to 11%, the highest level in the 30-year history of the data. Home equity loans have risen almost 40% in the last year. This reduces equity in home ownership. In the last quarter, there were over 400,000 bankruptcies, a record. The Tribune in Mesa, Arizona reported the following news about home foreclosures. The Mortgage Banks Association of America said that the Arizona foreclosure rates are rising. Over-funded mortgages at 125% of value are proving to be too much of a burden. The amount owed now exceeds the market value of the real estate.

“Don’t tell me what’s going to happen, tell me when,” one wise man once said. That’s why we turn to cycles, which can be linked to planets to enable us to make projections. If business is going to weaken, as my Planetary Economic Forecasting study suggests, then we face a burst in the bubble. Disposable income will fall, rendering many unable to make interest payments. This will bring prices down. Jupiter exited the sign of Cancer (traditionally associated with the home, in addition to being the USA Sun sign) early in August, and this likely removed some of the impetus to the housing surge. Also, production usually falls for the one and a half years after Jupiter exits the sign of the crab. Saturn will enter this sign next June, and I project that this is when the downturn will begin in earnest.

Strategy

Traders go short for the month. Investors should await a better low in October for longer-term purchases.

Quote of the Month:

“Today, the apologists of socialism are forced to distort facts and to misrepresent the manifest meaning of words when they want to make people believe in the compatibility of socialism and freedom.”
-Ludwig von Mises

Turning Points

The highest-probability S&P and DJIA turning points (+ or – 1 day) for the month are *(The stronger turning points are starred:)*

Sept. 3-4*	19-20*
9-10*	25-26*
17	

The highest-probability NASDAQ turning points (+ or – 1 day) for the month are *(The stronger turning points are starred*):*

Sept. 3	19-20*
9-10*	27-28

Recommended Stocks:

For the last 13 years, the health care sector has held up the best versus the S&P while the materials sector has performed worst in September. If traders seek potential short candidates, Calpine (CPN-9/20/96), Luxottica (LUX-1/24/90), Reynolds & Reynolds (REY-1/26/89), 3M (MMM-1/14/46), and JP Morgan (JPM-4/1/69) will likely be weaker than the average equity.

Hold:
NY Times <9/25/97> (NYT-47.2) was recommended at 46.6.
Campbell Soup <12/13/54> (CPB-23.15) was recommended at 29.

Note: This letter will be moving to Adobe’s PDF format in the near future. You will need to download Adobe Acrobat reader from their website to open it. This change will allow me to include graphs and charts, which readers have been unable to open in the current format.